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DECEMBER FISCAL CLIFF

Global markets continue to rally on worldwide central bank easing, material improvements in the US economy and on the assumption that policymakers in both Europe and the United States will continue to navigate the European debt crisis and the US December fiscal cliff. Investors also believe that recent stimulus in China will stabilize its growth rate at 7.5%.

Currently, in the US, "risk on" assets lead: energy, technology, telecommunications, consumer discretionary and financials. Safe haven "risk off" sectors lag: consumer staples, health care, REITs and utilities. International investments have begun to outperform the US market after **ten years of relative underperformance**. We recommend an overweight position in international investments, including Europe, as we expect it is time for the rest of the world to catch up with the US.

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The US rally could run up to the election if the positive influence of the four-year election cycle persists. Since 1928, in presidential election years, the third quarter average return was 5.1% and the fourth quarter was 2.0%.[1] Near term, we recommend being fully in equities but are nervous bulls. There are still a number of downside risks domestically and in the world, including the outcome of the US elections, the fiscal cliff, the China slowdown and the ongoing European financial crisis. We would not hesitate to get more defensive if the global economic or political environment deteriorates.

December Fiscal Cliff

The US "fiscal cliff" refers to a mix of significant tax cuts scheduled to expire at the end of 2012 and large spending cuts set to take effect in early 2013. Of greatest concern are: the Bush-era tax cuts, set to expire at the end of 2012 (1.5% of GDP), the expiring payroll tax cut (0.6% of GDP) and the "sequester" spending reductions required under the Budget Control Act of 2011 (0.4%). The total fiscal cliff could amount to more than $600 billion, the equivalent of a 4% drop in GDP.[2] There is already evidence that businesses are scaling back hiring and inventories ahead of potential steep year-end tax hikes and government spending cuts, the most concrete sign to date that uncertainty from the fiscal cliff is holding back the domestic economy. In addition, the debt ceiling will need to be raised again by early 2013, another opportunity for protracted political gridlock due in December. Nothing will happen to solve any of these problems before the election; the lame duck congress is unlikely to do anything significant before year end. Everyone knows these elephants are in the room. Nevertheless, we believe politicians will take some steps to reduce the amount of tightening and/or push most of the decisions into early next year. Our most likely scenario has: the Bush-era tax cuts at least partially extended, the Alternative Minimum Tax (ATM) adjusted for inflation and the "sequester" spending cuts deferred to later years. Thus, while some fiscal tightening will occur, it will not be as draconian as some investors may fear.

Current Economy

United States Economy

For the first time in seven years, the housing sector is no longer a drag on the economy but a positive force for growth. A broad range of housing indicators - existing home sales, consumers' expectations to buy a house, housing construction and home prices - have continued to improve. Last month, in contrast, factory jobs declined the most in two years…. and so it goes with a subpar growth economy. Since policymakers have a low tolerance for lackluster employment growth, the Fed had some room to ease, which they did, with a splash. On September 12th, the Fed announced **open ended quantitative easing**, offering to purchase $40 billion per month of mortgage-related debt until **the outlook for jobs improves substantially, so long as inflation remains contained**. They also said they were unlikely to raise rates **until mid-2015**.[3]

World Economy

The European Central Bank (ECB) rescued the global economy (for a while, again) by announcing a bond purchase program aimed at bringing down the yields of distressed sovereign debt. The ECB's most recent program would allow banks to sell their "bad" bonds to the central bank. Furthermore, the ECB will not impose a cap on these bond purchases, suggesting it will buy whatever is necessary to bring down bond yields to whatever level they think appropriate. The IMF will be involved with and support this bond buying policy. These are significant steps toward reducing risk in the European banking system. To be sure, none of this will solve Europe's chronic problems, but hopefully, policymakers will take advantage of the ECB backstop and commit to structural and banking system reform that will promote fiscal union and financial stability. The road to a European solution shall continue to be bumpy.

Growth in China has been slowing for the last six quarters. This decreasing growth rate has been another major concern for the global economy. Looking forward, there are some encouraging signs that the economy is stabilizing: the housing sector continues to recover, the non-manufacturing sector (services and government) remains robust and the government recently announced two huge stimulus programs. The first is $133 billion for 25 subway projects and the second is $157 billion for 60 large scale infrastructure projects to build highways, ports and airport runways. Premier Wen Jiabao said that China is on track to meet this year's growth target of 7.5% and if needed, the government could utilize a $16 billion fiscal stability fund to further boost growth.[4] Global growth may be starting to stabilize.

Asset Allocation

United States Bonds and Stocks

Treasury bonds appreciated 21% from late March until the end of July and have since come down some 8% in value as safe haven assets became less desirable. We think they could retrace the lows in March, an additional decline of 10%. We would recommend avoiding Treasuries until they approach that level. We favor mortgages, municipals, and high yield and investment grade corporate bonds with less than five year maturities. As long as the Fed keeps the economy out of a severe recession, high yield bonds offer an attractive yield differential over Treasuries. Cash and bonds are under weighted in portfolios.

Overweight US stocks. They continue to rally on an improving economy and the perception that if the economy slows too much the Fed will again prime the pump. The fears about Europe and China have abated for the time being and there is hope the fiscal cliff issue will resolve into something less precipitous. Overweight "risk on" sectors: telecommunications, information technology, consumer discretionary, industrials, materials and finance stocks; underweight consumer staples, health and utilities. We still recommend large cap over small even though the small cap universe has started to act better lately. While currently positive on the market, we also remain concerned with downside risks and will take defensive action if necessary.

International Stocks

International markets have underperformed the US market for the **last ten years**. Since 2007, international equities have given up 30% relative to the US. Most of the fear over the last couple of years has driven assets away from the rest of the world to the "safety" of the United States. If fears recede because of policy decisions in Europe and China, it would be reasonable to expect money to reverse course. Since June this is what is happening and international equities are doing better than the US. The two hardest hit areas were Europe (down 50% since 2007) and China (down 53.2%). Since early summer, Europe has roared, up 24.3%. We believe China is long overdue to play catch up. Portfolios are overweight international equities emphasizing the Far East and emerging markets but include Europe and China as well.

Natural Resources and Energy

Overweight natural resources and energy. Last spring this sector was down 31.3% from the prior year as investors feared a US recession and a global slowdown. Since June, the overall market has been led by energy, gold, gold stocks and other natural resource stocks as it became apparent central banks were accelerating their monetary easing programs. All portfolios should have precious metal positions because real interest rates are near zero, policymakers continue to be under pressure to ease and central banks continue to purchase bullion. Oil and other commodity prices are also going higher. Underlying oil fundamentals remain tight as OPEC output is decreasing due to Iran sanctions and geopolitical risks in the Middle East have resurfaced. Saudi output is at an all-time high; its ability to increase production will soon come under pressure. The risk to oil prices is to the upside.

Real Estate

The Fed's open ended commitment to purchase mortgage-related securities and keep short rates low for another 3 years is beneficial to real estate. REITs have done quite well over the last couple of years because they acted as a defensive play with a relatively high yield. Consequently, they tend to perform in line with "risk-off" assets. We would underweight this sector due to historically high valuations owning only companies with strong balance sheets and near-term growth forecasts.

Summary

Central bankers around the world are committed to prevent any kind of recessionary tendencies in their economies. This is best exemplified by the ECB's unlimited purchase program of sovereign debt and the Fed's unlimited buying of mortgage-related debt. For the time being, "don't fight the central bankers" is a good motto to live by. We favor those areas that are participating in the current risk on trade: telecommunications, information technology, consumer discretionary, industrial, materials and finance stocks. We are underweight cash, bonds and REITs, and overweight U.S. stocks, international equities, natural resources and energy.

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[1] www.wsj.com
[2] www.GoldmanSachs.com
[3] www.wsj.com
[4] www.wsj.com

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